September 24, 2007

Via Email

Nicholas Bianco
MassDEP
One Winter Street, 6th Floor
Boston, MA 02108

Robert Sydney
DOER
100 Cambridge Street, Suite 1020
Boston, MA 02114

Re: Proposed Carbon Dioxide (CO2) Budget Trading Program

Dear Mr. Bianco and Mr. Sydney:

The Conservation Law Foundation ("CLF") offers the following comments regarding the implementing regulations for the CO2 Budget program and the allowance auction that is an integral part of that program (collectively, "the RGGI regulations").

Our specific comments, which follow a brief introduction and presentation of context, have three components. First, we address the issues regarding the allowance auction design and rules, allowance revenue spending and related questions that fall uniquely without the jurisdiction of the Massachusetts Division of Energy Resources ("DOER"). Next, we focus on the regulations of the Massachusetts Department of Environmental Protection ("DEP") and the issues that are wholly specific to those regulations and the role that DEP plays. Lastly, we focus on the "cross-cutting" questions that play out in both sections, in larger policy questions that will shape the regional implementation process and the continued process of turning this CO2 Budget Program and the larger RGGI effort into a more effective tool in the fight to control greenhouse gas emissions.

I. Context and Introduction

DEP and DOER do not need any education on the absolute need to shift our economy and society to a clean energy path - reducing the constant drain on our economy due to the export of money from the Commonwealth to purchase high carbon fossil fuels while simultaneously beginning the essential task of reducing our greenhouse gas emissions.

As the DEP staff knows, this last task of reducing greenhouse gas emissions is not about some abstract need to protect the planet as a whole – it is about protecting the Commonwealth and its citizens. We should not forget that earlier this year the U.S. Supreme Court predicated its groundbreaking decision in Massachusetts v. EPA[1] on a determination that the Commonwealth (and by extension the other plaintiffs/petitioners which, we are proud to note, include CLF) had standing to bring the case, at least in part, because of "Massachusetts' well-founded desire to preserve its sovereign territory today." Massachusetts v. EPA, 127 S.Ct. 1438, 1454 (2007). The court found that the "injury" to the Commonwealth from rising sea levels caused by global warming were real and imminent, specifically noting that, "The severity of that injury will only increase over the course of the next century. If sea levels continue to rise as predicted, one Massachusetts official believes that a significant fraction of coastal property will be either permanently lost through inundation or temporarily lost through periodic storm surge and flooding events." Massachusetts v. EPA at 1456.

To be blunt, the strong (and accurate words) of the officials of the Commonwealth have moved the Supreme Court and, by extension, national law and policy and those same words should galvanize even stronger action here and now.

So what does all this mean for our rulemaking? The answer is clear: DOER and DEP have an absolute obligation to design, implement and operate this program in a manner that achieves the deepest possible emissions reductions. The program is at heart a mild one that seeks only to make the very first incremental reductions from only one sector of our economy (and not the largest sector at that) and it is a very, very flexible program that provides a broad range of compliance options including bringing in allowances budgeted to other states, allowance banking, multi-year compliance and overly generous use of off-sector offsets. It is essential that the emissions budget not be inflated any further through inappropriate conversion of MA GHG credits, use of Construction and Demolition waste as "biomass" or any of the other schemes, plans or mechanisms that would "ease the compliance burden" on emitters. Such "easings" would only undermine the program.

II. DOER – AUCTION DESIGN AND OPERATION ISSUES & USE OF ALLOWANCE REVENUES

A key theme of our comments to DOER regarding auction design is a simple plea to not extend special rights to generators in the conduct of the auction. Indeed, the hints that such rights may be extended to them in the future should be removed from the regulations. Specifically, the creation of "categories" of auction participants, coupled with a regulatory provision stating that the auction could be closed to any of these categories of participants, is a major mistake. Provisions to that effect, found in 225 CMR 3.08 of the draft regulations, should be removed entirely. Any decision to close the auction to any participants in the future should be the subject of a separate and clear exercise in notice and comment rulemaking.

[1] Massachusetts v. EPA, 127 S.Ct. 1438 (2007).

Of course, the fundamental reason for keeping the auction open is to ensure as fluid, dynamic and efficient an auction as possible by bringing as many participants to the table as possible – defusing opportunities for market power, gaming and monopsony behavior (or more accurately oligopsony[2] power). The closed world of large scale electric generation and associated trading is a perfect breeding ground for oligopsonic and collusive behavior by the small number of generators – collapsing the RGGI auction market down into this small pool of participants is an open invitation to gaming.

One way of defusing this problem of market power and gaming is both to open up the pool of buyers (as discussed above) and also to expand the pool of sellers. This means that Massachusetts should do all that it can to move forward the regional auction. This does not mean backing away from the language in the draft regulations that empowers DOER to conduct a Massachusetts auction. Rather it means that language should be added to the regulations that clarifies that this authority could be delegated to a multi-state regional auction and to the cover letter and final Statement of Reasons making it clear that the Commonwealth would favor a regional auction.

More counter intuitively, the requests for "price and information transparency" by the generators should be viewed with suspicion because of these market power concerns. Posting long-term contract prices increases the likelihood those participants will exercise market power (through gaming). One case study of this phenomenon comes to us from California. It found that the transmission of information by the System Operator ("CAISO") via the web based "OASIS" system to market participants appears to increase the average price of electricity, as does the publishing of emergency conditions.[3] The likely outcome from a market that provides too much information to participants with a strong incentive to collude and game is to increase mimetic behavior and the potential for implicit market collusion. There is ample reason to believe that this same behavior could occur in a limited-buyer oligopsony/monopsony situation as readily as in a limited-seller oligopoly/monopoly context. This concern underlies the decision by the expert team working on the regional auction design to embrace innovate information control and anti-gaming mechanisms like the "shoot-out round" auction design concept, a concern recognized by DOER's adoption of that unique and interesting auction methodology in the regulations.

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[2] An online reference work describes an oligopsony as being, "Similar to an oligopoly (few sellers), this is a market in which there are only a few large buyers for a product or a service. This allows buyers to exert a great deal of control over the sellers and can effectively drive down prices." www.investopedia.com/terms/o/oligopsony.asp.

[3] E. Woychik and B. Carlsson, *How Enron et al. Gamed the Electricity Market: An Empirical Analysis of Trader Knowledge*, Journal of International Business and Economics at p. 10 (forthcoming 2007) available at http://www.trintrin.com/gebc/How%20Enron%20et%20al%20Gamed%20The%20Electricity%20Market%20An%20Empirical%20Analysis%20of%20Trader%20Knowledge.doc

A different, but equally critical, auction design question is that of a reserve price. Massachusetts should lead the regional auction design towards the conclusion (supported by a broad consensus of economists, as well as by common sense and the environmental protection goals of the program) that a reserve price be set and then, if the market informs us that the allowances have little value because that price is not being met, those unsold allowances should be retired. For the reasons set forth above concerning the potential misuse of information in fueling collusive and gaming behavior, it would be appropriate to keep the precise reserve price confidential – otherwise it is very likely that the allowance prices in the auction would cluster just at, or slightly above, the openly disclosed reserve price.

DOER should be applauded for opening the door towards setting a reserve price in the proposed 225 CMR 13.06(7) but should go further by mandating a reserve price and, for the reasons set forth above, should keep that reserve price undisclosed.

Also, as discussed above, if allowances remain unsold (because of failure to reach the reserve price) after several quarterly auctions, then a clear signal is coming from the market regarding the lack of value of the allowances, most likely because of a realization that there is an oversupply. In this case, contrary to the current wording of proposed 225 CMR 13.06(6), the unsold allowances should be retired. By failing to allow for such retirement to correct for over allocation and resulting market failure DOER is inappropriately tying its own hands.

III. DEP ISSUES

In designing and implementing this program DEP should strive to maintain consistency with other environmental protection programs that DEP administers, as well as consistency with the RGGI Memorandum of Understanding (MOU) and Model Rule that is the bedrock of the program. These principles and the underlying need to maintain the integrity of the program and advance its fundamental greenhouse gas emissions goals dictate certain decisions about its design and implementation. Happily, DEP's draft regulations largely follow this path - and the final regulations should echo the same conclusions.

One area where there is pressure from some commenters to deviate from the path set by the MOU and Model Rule is with regard to the definition of biomass. It is essential that DEP refuse to entertain any attempt to undermine the integrity of the program by moving away from the principle that biomass must be "sustainably harvested woody and herbaceous fuel sources that are available on a renewable or recurring basis." See, proposed 310 CMR 7.70(1). DEP should make it clear in its explanatory materials that by specifying as eligible biomass, "clean organic wastes not mixed with other solid wastes, biogas, and other neat liquid biofuels derived from such fuel sources" it is clearly and explicitly excluding "solid wastes" from the list of eligible biomass fuels.

Likewise, it is essential that the demands from generators that emergency exemption language or other "escape hatches" be added to the program be rejected.

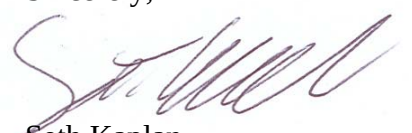
There should also be further clarification regarding the integration of the pre-existing (although never implemented) "GHG Credit" scheme. In particular, it appears that DEP intended for proposed 310 CMR 7.70(10)(c)(4)(e) and related provisions to ensure that only RGGI eligible offset projects would receive RGGI allowance credit – a vital concern as allowing other sources of offsets to earn offset (and thereby allowance) credit would undermine the entire regional program. This intention should be made plain and clear.

IV. CROSSCUTTING ISSUES

DEP and DOER should be complemented for choosing to implement the mechanism provided by the Model Rule for retirement of allowances in order to preserve the voluntary renewable energy market. See, proposed 310 CMR 7.70(5)(c)(1)(b). However, this decision is undermined by the arbitrary cap placed on the number of allowances that could be retired under this provision. See, proposed 310 CMR 7.70(5)(c)(1)(b)(iii). It appears that even modest success in the marketing and deployment of current, proposed and pending voluntary purchase programs (the National Grid Green-Up program, the NSTAR Green program, and the RFP for purchase of renewable energy by the agencies of the Commonwealth) will result in the sale of sufficient RECs to reach the cap in very short order - sharply limiting this developing market.

Finally, we urge DEP and DOER to not fall into the trap of the Maine legislation which delays implementation of their version of this program until a set amount of other states have adopted parallel regulations and are ready to implement them (See 38 Maine Revised States Ann. 580-B(2)). As the largest source of greenhouse gas emissions in New England, the Commonwealth has an obligation to lead the region – not to follow it. In order for this regional program to succeed, the larger states, including Maryland, New Jersey, New York, Connecticut and Massachusetts, will need to launch it.

Sincerely,



Seth Kaplan